CHAPTER

I

SUPERVISION OF THE BANKING SECTOR

1. Developments in the banking sector in 2002
2. Changes in the regulatory framework
3. Prudential supervisory practice

1. Developments in the banking sector in 2002

1.1. Characteristics of the Luxembourg banking sector

Luxembourg banking law recognises three types of banking licence, namely licences governing the activities of universal banks (174 institutions having this status on 31 December 2002), those governing the activities of banks issuing mortgage bonds (3 institutions having this status on 31 December 2002) and those governing the activities of banks issuing electronic means of payment (no institution having this status on 31 December 2002).

The universal banks comprise three categories according to legal status and geographical origin:

- banks under the law of Luxembourg (119 on 31 December 2002);

- branches of banks originating from a Member State of the European Union (48 on 31 December 2002);

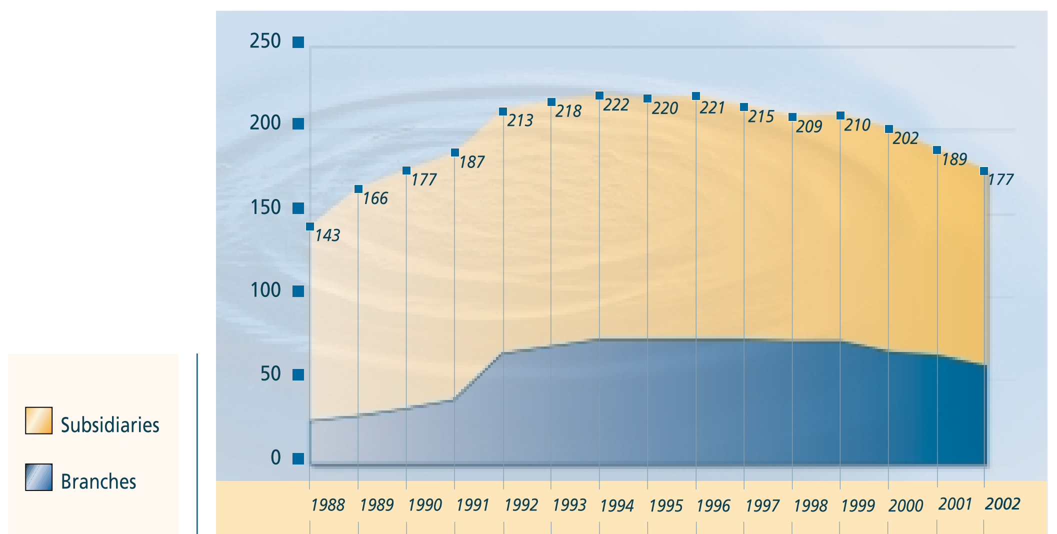
- branches of banks originating from non-Member States of the European Union (7 on 31 December 2002)

In addition, there is the special case of the unit formed by the caisses rurales (34 on 31 December 2002) and their central establishment, the Banque Raiffeisen, which, according to the law relating to the financial sector, is to be considered as a single credit institution.

1.2. Developments in the number of credit institutions

The number of credit institutions established in Luxembourg further declined during 2002, thereby confirming the downward trend observed since 1999. Indeed, the total number of banks only amounts to 177 as at 31 December 2002, compared to 189 as at 31 December 2001. The 177 entities comprise only 122 Luxembourg-incorporated banks (2001: 128) and 55 branches (2001: 61).

Developments in the total number of banks established in Luxembourg



The development of the total number of credit institutions is notably dependent on the following phenomena:

- Mergers, generally originating in the restructuring of parent companies abroad, necessarily affect their Luxembourg presences. The withdrawal of seven banks was due to this reason;

- On the other hand, the transformation of German branches into subsidiaries needs to be noted: the branches of Kölner Bank and of Volksbank Hannover became KHB International S.A and Frankfurter Volksbank became Frankfurter Volksbank International S.A.;

- One branch, Conrad Hinrich Donner Bank, became an "other professional of the financial sector";

- Finally, five banks ceased their activities.

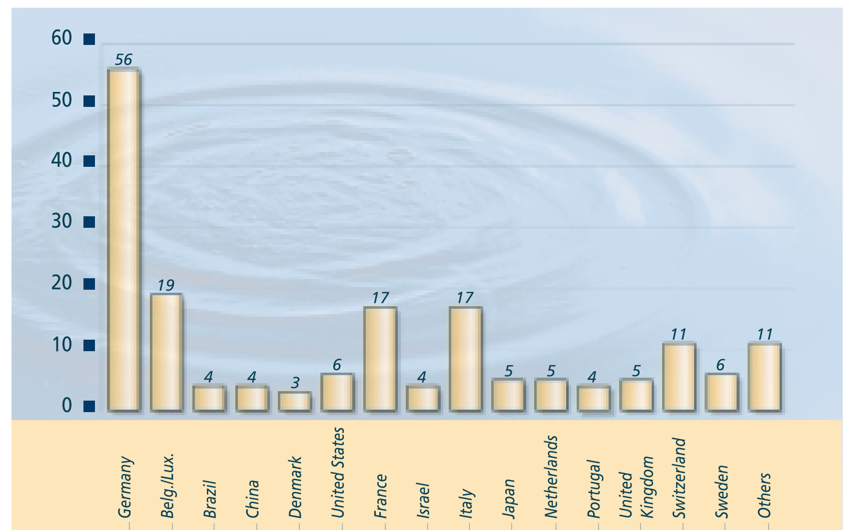
Liquidations / mergers	*Date of withdrawal from the official list of credit institutions*
Banca Intesa International S.A.	Merger with Société Européenne de Banque S.A. on 01.01.2002
DekaBank Luxembourg S.A.	Merger with Deutsche Girozentrale International S.A. on 01.01.2002
Volksbank Hannover, Luxembourg branch	Withdrawal on 28.02.2002
Kölner Bank, branch	Withdrawal on 28.02.2002
Banque Leu (Luxembourg) S.A.	Merger with Crédit Suisse (Luxembourg) S.A. on 25.03.2002
Vereins- und Westbank A.G., Luxembourg branch	Withdrawal on 31.05.2002
Banca Popolare di Verona – Banco S. Geminiano e S. Prospero, Luxembourg branch	Merger with Banca Popolare di Novara, Luxembourg branch on 01.06.2002
Frankfurter Volksbank, branch	Withdrawal on 01.07.2002
Artesia Bank Luxembourg S.A.	Merger with Banca Lombarda International S.A. on 22.07.2002
Banque Ferrier Lullin (Luxembourg) S.A.	Merger with UBS (Luxembourg) S.A. on 31.08.2002
SanPaolo IMI SpA, Luxembourg branch	Withdrawal on 30.09.2002
Prudential-Bache International Bank, Luxembourg branch	Withdrawal on 31.10.2002
Dexia Nordic Private Bank Luxembourg S.A.	Merger with Dexia Banque Internationale à Luxembourg on 01.11.2002
Conrad Hinrich Donner Bank, Luxembourg branch	Transformation into PFS on 26.11.2002
Banco di Sicilia International S.A.	Withdrawal on 16.12.2002
Fairbank	Withdrawal on 24.12.2002

As regards new official registrations of credit institutions, two branches of European banks need to be mentioned: BNP Paribas Securities Services and ING BHF-Bank. These entities belong to groups already established in Luxembourg and their establishment results from considerations regarding the internal organisation of the groups.

Name of institution	*Shareholders*	*Date of official registration as a credit institution*
KHB International S.A. Luxembourg	Volksbank Hannover, Hannover Kölner Bank, Cologne	1 March 2002
BNP Parbas Securities Services, Luxembourg branch	BNP Paribas Securities Services, Paris	1 June 2002
Frankfurter Volksbank International S.A.	Frankfurter Volksbank eG, Frankfurt	1 July 2002
ING BHF-BANK, Luxembourg branch	ING BHF-BANK AG, Frankfurt	1 August 2002

The breakdown of credit institutions according to geographical origin has changed as follows (figures of 2001 between brackets). Banks of German origin are still the highest in number, with 56 (59) entities, followed by Belgian and Luxembourg banks, with 19 (20) entities. Other banks originate from France with 17 (17) entities, Italy with 17 (21) entities, Switzerland with 11 (12) entities, Sweden with 6 (6) and the United States with 6 (6) entities.

Geographic origin of banks



1.3. Developments in the local branch networks in Luxembourg

The downward trend in branch networks recorded since the 1990s continued in 2002, as shown below.

	1994	1995	1996	1997	1998	1999	2000	2001	2002
Number of local branches	262	260	254	240	231	226	225	214	207
Number of banks concerned	11	11	11	11	11	10	9	9	8

The reduction in the number of local branches is one of the phenomena reflecting the general trend towards increased concentration in the sector. In this case, concentration takes place on a more local level, mainly affecting a specific type of activity, namely retail banking, and is motivated by cost-cutting measures. The services traditionally provided by local branches are being increasingly substituted by technical facilities (ATMs, home banking, phone banking, internet banking, etc.).

On the other hand, certain banks tend to relinquish the concept of small convenience branches providing only retail services for the benefit of larger branches, which serve, besides the customers of the retail banking, also private banking customers, and which dispose of an adequate infrastructure for this type of activity.

1.4. Developments in banking-sector employment

Total employment on 31 December 2002 reached 23,300 against 23,861 on 31 December 2001, representing a decrease of 2.35%. This fall concerns Luxembourg as well as foreign employees.

This general trend conceals of course disparate developments in the different banks concerned. Two thirds of the banks did not cut their workforce, or even slightly increased it. However, large banks with branch networks as well as important subsidiaries of German banks are among those banks having decreased their workforce.

Another factor concerns the trend towards outsourcing of certain functions or activities, which implies that the reduction in banking employment does not necessarily translate a dead loss in employment, but, at least in part, a transfer of personnel to different entities, in principle belonging to the same group and located in Luxembourg. The outsourcing trend concerns activities such as information technology as well as UCI management, private portfolio management, company domiciliation, etc..

Distribution of the number of employees per bank

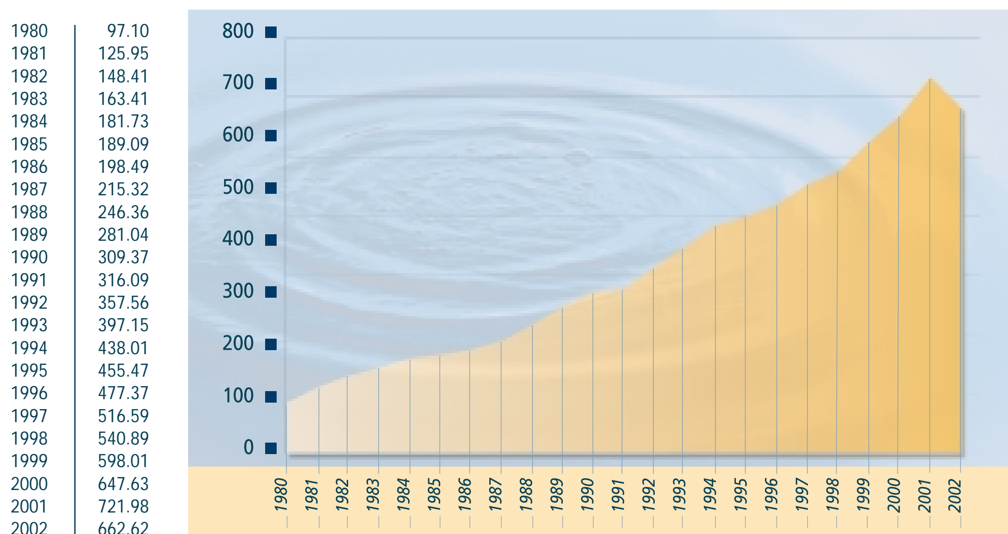
Number of employees	Number of banks	
	2001	2002
> 1000	4	4
500 to 1000	5	6
400 to 500	4	3
300 to 400	4	7
200 to 300	12	9
100 to 200	16	18
50 to 100	26	23
< 50	118	105

	Total		Management			Office staff			Technical staff			Total workforce		
	Luxemb.	Foreigners	Men	Women	Total	Men	Women	Total	Men	Women	Total	Men	Women	Total
1991	-	-	1957	253	2210	6250	7089	13339	85	311	396	8292	7653	15945
1992	-	-	2030	294	2324	6312	7111	13423	84	312	396	8426	7717	16143
1993	8158	8567	2097	335	2432	6713	7396	14109	68	116	184	8878	7847	16725
1994	8116	9522	2308	384	2692	7086	7700	14786	47	113	160	9441	8197	17638
1995	8170	10113	2533	451	2984	7318	7813	15131	49	119	168	9900	8383	18283
1996	8113	10469	2658	490	3148	7476	7809	15285	48	101	149	10182	8400	18582
1997	8003	11086	2765	547	3312	7631	8013	15644	44	89	133	10440	8649	19089
1998	7829	12005	2900	577	3477	7846	8377	16223	47	87	134	10793	9041	19834
1999	7797	13400	3119	670	3789	8362	8961	17323	34	51	85	11515	9682	21197
2000	7836	15232	3371	783	4154	9030	9801	18831	35	48	83	12436	10632	23068
2001	7713	16148	3581	917	4498	9222	10046	19268	33	62	95	12836	11025	23861
2002	7402	15898	3652	977	4629	8943	9657	18600	25	46	71	12620	10680	23300

1.5. Developments in balance sheet totals

Balance sheet totals posted by credit institutions fell to EUR 662,620 million at the end of the year 2002 from EUR 721,978 million at the end of 2001, recording a drop of 8.2% during 2002.

Developments in balance sheet totals posted by credit institutions - *in billions of EUR*



Aggregated balance sheet totals of the Luxembourg financial centre - *in millions of EUR*

ASSETS	*2001*	*2002*[1]	*Variation in %*	*LIABILITIES*	*2001*	*2002*[2]	*Variation in %*
Loans and advances to credit institutions	362,234	342,696	-5.39%	Amounts owed to credit institutions	341,512	311,608	-8.76%
Loans and advances to customers	146,206	127,261	-12.96%	Amounts owed to customers	230,119	210,574	-8.49%
Fixed-income securities	149,475	142,716	-4.52%	Debts evidenced by certificates	72,208	71,801	-0.56%
Variable-yield securities	4,352	3,811	-12.42%	Various items	16,618	6,272	-62.26%
Participating interests and shares in affiliated undertakings	9,804	9,666	-1.41%	Permanent(*) shareholders' equity	61,521	62,364	+1.37%
Fixed assets and other assets	49,908	36,469	-26.93%	*Of which profit for the year*	*2,855*	*2,648*	*-7.25%*
Total	**721,978**	**662,620**	**-8.22%**	**Total**	**721,978**	**662,620**	**-8.22%**

(*) Including share capital, reserves, subordinated liabilities and provisions.

[1] *Preliminary figures for the year ending 31.12.2002.*
[2] *Preliminary figures for the year ending 31.12.2002.*

- **Assets**

As regards assets, the drop in the balance sheet total essentially stems from a reduction in loans and advances to credit institutions and to customers.

Loans and advances to credit institutions fell by 5.4% in 2002 reaching EUR 342,696 million compared to an increase of 13.4% in 2001. This fall namely stems from the fact that several important loans, which became due in 2002 have not been renewed. In 2002, this item represented 51.7% of the balance sheet total against 50.2% in 2001.

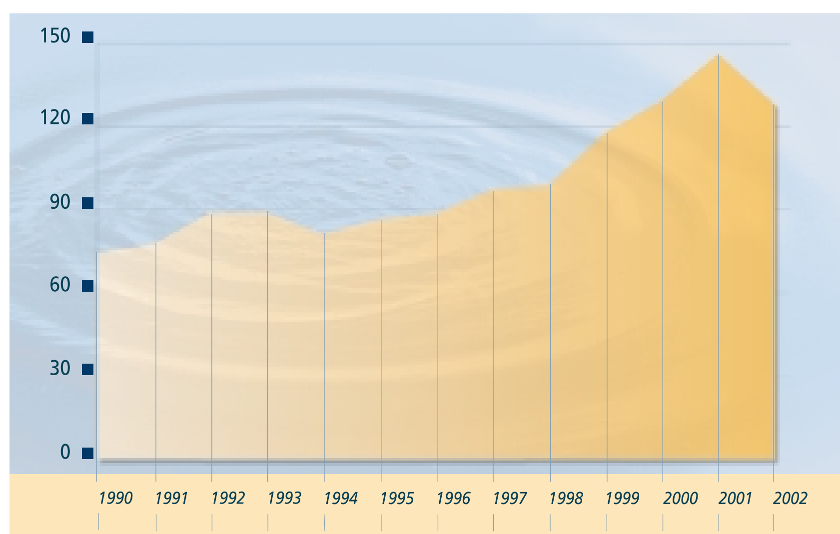
Qualitative breakdown of interbank assets

	2000	*2001*	*2002*
Central and multilateral banks	0.29%	0.33%	0.30%
Banks Zone A[3]	98.47%	98.62%	98.44%
Banks Zone B[4]	1.23%	1.05%	1.26%

This breakdown shows that almost all loans and advances to credit institutions consist of commitments on banks of Zone A, i.e. banks of industrialised countries. The breakdown in relative terms remained relatively stable over the last three years.

The item loans and advances to customers fell by 13% and amounts to EUR 127,261 million, i.e. 19.2% of the balance sheet total, compared to EUR 146,206 million in 2001.

Developments in loans and advances to customers *- in billions of EUR*



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[3] *Countries Zone A: Germany, Saudi Arabia, Australia, Austria, Belgium, Canada, South Korea, Denmark, Spain, United States, Finland, France, Greece, Hungary, Ireland, Iceland, Italy, Japan, Liechtenstein, Luxembourg, Mexico, Norway, New Zealand, Netherlands, Poland, Portugal, United Kingdom, Slovakia, Sweden, Switzerland, Czech Republic, Turkey.*

[4] *Countries Zone B: all countries other than Zone A.*

Breakdown of loans and advances to customers

	2000	2001	2002
Public authorities Zone A	5.23%	4.68%	5.60%
Public authorities Zone B	0.45%	0.30%	0.19%
Private customers and financial institutions	94.25%	94.97%	94.15%
of which: legal entities	*58.64%*	*54.14%*	*55.00%*
of which: natural persons	*19.59%*	*18.33%*	*21.37%*
of which: financial institutions	*21.77%*	*27.53%*	*23.62%*
Leasing	0.05%	0.05%	0.05%

Qualitative breakdown of loans and advances to private customers and financial institutions

Loans and advances to private customers and financial institutions	2000	2001	2002
Secured by public authorities	2.46%	2.94%	3.97%
Secured by credit institutions	19.54%	17.69%	17.97%
Secured by other tangible securities	27.95%	27.97%	31.61%
Unsecured	50.05%	51.40%	46.44%

The volume of loans and advances to financial institutions fell by 26% from 2001 to 2002. Loans and advances to legal entities dropped by 12.4% whereas the volume of loans and advances to natural persons remained relatively stable. These movements essentially stem from a reduction in credit activity of subsidiaries of German banks. Globally, this resulted in a fall in relative terms of loans and advances to financial institutions, which only represent 23.6% of total loans and advances to customers. Loans and advances to legal entities and natural persons increased in relative terms, representing 55.0% and 21.4% respectively of loans and advances to private customers at the end of 2002. Loans and advances to public authorities, generally in the form of securities, slightly grew in relative terms in 2002, but are still only fairly represented.

The secured part of loans and advances grew substantially in 2002. This development is essentially due to the reduction in volume of unsecured credits.

The portfolio of fixed-income transferable securities decreased by 4.5% reaching EUR 142,716 million at the end of 2002. A reduction in absolute terms of positions on banks of industrialised countries explains this development. Securities issued by banks of industrialised countries and those issued by the public sector still form the most important part of the portfolio of fixed-income transferable securities.

Qualitative breakdown of fixed-income transferable securities

	2000	2001	2002
Public sector Zone A	25.71%	24.10%	24.52%
Public sector Zone B	1.27%	0.97%	0.61%
Credit institutions Zone A	51.58%	50.98%	50.83%
Credit institutions Zone B	1.19%	1.06%	0.97%
Other issuers Zone A	15.62%	17.57%	18.74%
Other issuers Zone B	4.63%	5.33%	4.34%

The volume of the portfolio of variable-yield transferable securities, i.e. equities, remains marginal, since Luxembourg banks are not very active in own-account trading of such stocks. The portfolio continues to register important losses in volume owing to disappointing stock market performance over 2002.

The item Participation interests and shares in affiliated undertakings slightly fell in 2002 (-1.4% as compared to 2001), while it had recorded a significant rise over several years. Participating interests in banks, representing almost the whole item, dropped over the year due to the depreciation of certain investments.

- **Liabilities**

As regards liabilities, amounts owed to credit institutions and amounts owed to customers almost decreased to the same extent.

Amounts owed to credit institutions totalled EUR 311,608 million (-8.8% as compared to 2001). The interbank market is still, with 47% of liabilities, the main source of refinancing for banks.

Amounts owed to customers, representing 32% of total liabilities, fell by 8.5% and reached EUR 210,574 million at the end of 2002. All the categories of amounts owed to customers were affected by this decline.

In relative terms, deposits from the public sector recorded the strongest drop and continue to decrease compared to their exceptionally high level in 2000 (-56.5% for the year 2002).

Breakdown of amounts owed to customers

	2000	*2001*	*2002*
Amounts owed to the public sector	7.4%	5.9%	2.8%
Amounts owed to legal entities	64.1%	63.8%	66.3%
Amounts owed to natural persons	28.5%	30.2%	30.9%

The amounts owed represented by securities remained almost stable in absolute terms compared to 2001. Their part in liabilities however continued to grow and reached 10.8% at the end of 2002. The amounts owed represented by securities remain an interesting source of financing especially for banks issuing mortgage bonds.

Permanent shareholders' equity, composed of core equity capital and subordinated debts, increased by 1.4%[5].

1.6. Movements in profit and loss account

Despite the global economic slowdown, the Luxembourg banking sector achieved a considerable net result in 2002 of EUR 2,658 million, representing however a fall as compared to the record of 2001. Due to the spectacular increase of the creation of provisions (+114%), reflecting a depreciation of certain assets, the net result decreased by 7% as compared with 2001.

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[5] *See also Chapter I, point 1.8 relating to developments in own funds and solvency ratio.*

Profit and loss account - *in millions of EUR*

	2000	Relative share	2001	Relative share	2002[6]	Relative share
Interests and dividends received	47,996		51,942		40,670	
Interest paid	44,467		47,560		36,577	
Interest-rate margin	**3,529**	**47%**	**4,382**	**55%**	**4,094**	**51%**
Commission income	3,035	40%	2,792	35%	2,611	33%
Income from financial operations	488	6%	355	4%	261	3%
Other income	465	6%	410	5%	1,029	13%
Banking income	**7,517**	**100%**	**7,939**	**100%**	**7,994**	**100%**
General administrative expenses	3,016	40%	3,227	41%	3,188	40%
Of which : staff costs	*1,588*	*21%*	*1,758*	*22%*	*1,809*	*23%*
Of which : other administrative expenses	*1,393*	*19%*	*1,470*	*19%*	*1,379*	*17%*
Depreciation	306	4%	396	5%	306	4%
Result before provisions	**4,195**	**56%**	**4,316**	**54%**	**4,500**	**56%**
Creation of provisions	1,520	20%	1,261	16%	1,799	23%
Write-back of provisions	767	10%	725	9%	652	8%
Taxes	1,013	13%	920	12%	694	9%
Result for the financial year	**2,429**	**32%**	**2,861**	**36%**	**2,658**	**33%**

The **interest-rate margin** fell by 7%, reaching EUR 4,094 million. On the one hand, this drop is explained in part by a decrease in volume, the balance sheet total having decreased by 8%. On the other hand, market opportunities to manage maturities were less favourable than in the previous year, since short-term and long-term interest rates developed similarly. Maturity management allows banks to earn a positive spread by funding longer term assets with shorter term liabilities, principally on the interbank market. The banks, having formed or acquired a network of subsidiaries abroad, were hard hit by the drop in dividends from these subsidiaries. These dividends, which appear under the item interest-rate margin, fell by 31% in 2002.

(in millions of EUR)	*2000*	*2001*	*2002*
Dividends received on participating interests	433	652	448

The reduction in **commission income** reflects a stock market situation that is more difficult than ever. It results from a combined decrease of the number of transactions and assets under management, the stock of which has been decreasing for two consecutive years. Nevertheless, the fall in commission income (-6%) is less marked than in 2001.

Income from financial operations, reflecting the banks' trading operations, only contributes in marginal terms to banking income. This activity is still not very developed among Luxembourg banks.

The slight growth of the banking income (+1%) stems from the item **other income**, the exceptional rise of which (+151%) more than offsets the drop of other banking income. The rise results from extraordinary income from the sale of participating interests, notably those of Cedel International (currently Clearstream). Realised capital gains reached the considerable amount of EUR 850 million in 2002.

[6] *Provisional figures for the year ending 31.12.2002.*

Faced with a decline of operating income, banks respond by cutting their expense budgets. Compared to 31 December 2001, this effort of cost-cutting resulted in a decrease of 1% of **general costs**, operating costs falling by 6%. Staff costs rose by 3% due to staff restructuring plans.

The relative control of expenses allows a gross result increase of 4%. Hence, the cost/income ratio was brought to 44%, against 46% in 2001. This ratio is still favourable compared with the norm of 50%, which the major bank groups generally set as a target.

The banks increased their **net creation of provisions** by 114%. This spectacular strengthening reflects the cautious attitude of banks as regards risk prevention as well as the depreciation of assets in the present economic context. This aggregated figure conceals however very disparate developments. Thus, the main part of the increase concentrates on a small number of banks, which are forced to adjust the value of their participations paid at a high price when the last economic cycle was at its highest level.

Finally, the substantial drop in **taxes** is due to the tax exemption on extraordinary capital gains.

Structural ratios

	2000	*2001*	*2002*
Cost/income ratio	44.2%	45.6%	43.7%
Profit before taxes/assets	0.5%	0.5%	0.5%
Profit before taxes/weighted assets	21.1%	22.4%	21.0%
Profit before taxes/core capital	16.9%	17.5%	14.2%
Interest margin/banking income	47.0%	55.2%	51.2%
Income excluding interest/banking income	53.0%	44.8%	48.8%
Interest margin/ average assets	0.56%	0.64%	0.59%
Creation of provisions for loans and advances to customers[7]	1.04%	0.95%	1.02%
Creation of provisions for affiliated undertakings[8]	0.76%	1.21%	11.88%
Creation of provisions for participations[9]	1.60%	3.23%	11.73%

It is noteworthy that the creation of provisions for loans and advances to customers remained stable, reflecting an unchanged quality of loans to the non-bank customers. On the other hand, the creation of provisions for affiliated undertakings and participations grew substantially. This increase explains the spectacular increase by 114% of the item creation of provisions.

Movement in certain indicators of profit and loss account per employee

(in millions of EUR)	*2000*	*2001*	*2002*
Banking income/employee	0.326	0.333	0.343
Staff costs/employee	0.070	0.075	0.078

There has been a rise in banking income per employee over the last three years. The rise in staff costs per employee can be explained basically by a comparatively more sustained growth in executive employees in terms of total employment[10].

[7] *As a % of gross amount.*
[8] *As a % of gross amount.*
[9] *As a % of gross amount.*
[10] *See also Chapter I, point 1.4. relating to developments in banking sector employment.*

1.7. Financial derivatives

Banks in the Luxembourg financial centre used derivatives totalling EUR 700.2 billion in 2002 as compared with EUR 829.9 billion in 2001, representing a decrease of 15.6%. Hence, the use of financial derivatives slightly fell compared to the year 2001, during which it had substantially grown compared with 2000. The ratio between the volume of derivatives and the balance sheet total reached 105.7% in 2002 against 115% in 2001.

This decrease mostly concerns options, which represent a volume of EUR 29.6 billion in 2002 against EUR 167.1 billion in 2001, which is a decrease of 82.3%. The decrease particularly concerns options traded on regulated markets and have thus affected the total volume of instruments traded on regulated markets: EUR 12.5 billion in 2002 against EUR 145.5 billion in 2001, representing a decrease of 91.5%.

However, the significant volume of options in 2001 was rather an exception and could be explained by covered issuing operations for a small number of specialised credit institutions.

Instruments traded over-the-counter still remain the most widely used products (97.1% of the total in 2002, as against 81.8% in 2001), with a volume amounting to EUR 679.8 billion in 2002 as compared to EUR 678.6 billion in 2001.

The volume of interest rate swaps, particularly used within the framework of the asset-liability management, grew a further 3.7% (EUR 639.0 billion in 2002 as against EUR 616.4 billion in 2001). Interest-rate swaps remained the most significant instrument in terms of volume.

Besides the interest-rate swaps, the only instrument recording a growth as compared with 2001 are futures (currencies, interest rates, other rates), although their volumes are small: EUR 7.9 billion as against EUR 5.8 billion in 2001, representing an increase of 36%.

Use of financial derivatives by credit institutions

Instrument	*2001*		*2002*	
	in billions of EUR	*as a % of total balance sheet*	*in billions of EUR*	*as a % of total balance sheet*
Interest rate swaps	616.4	85.4%	639.0	96.4%
Future or forward rate agreements	40.6	5.6%	23.6	3.6%
of which: over the counter	*37.8*	*5.2%*	*21.8*	*3.3%*
of which: regulated market	*2.8*	*0.4%*	*1.8*	*0.3%*
Futures (currencies, interest rates, other rates)	5.8	0.8%	7.9	1.2%
Options (currencies, interest rates, other rates)	167.1	23.1%	29.6	4.5%
of which: over the counter	*24.3*	*3.4%*	*18.9*	*2.9%*
of which: regulated market	*142.8*	*19.8%*	*10.7*	*1.6%*

1.8. Developments in own funds and in the solvency ratio

1.8.1. Number of banks required to calculate a solvency ratio

As at 31 December 2002, the number of banks required to meet a non-consolidated solvency ratio stood at 123, 122 of which were under Luxembourg Law and one branch of non-EU origin. Among these banks, 99 carry out limited trading activities, and are therefore authorised to calculate a simplified ratio. Trading activities in the true sense remain confined to a limited number of banks.

Number of banks required to meet a solvency ratio	*Integrated ratio*		*Simplified ratio*		*Total*	
	2001	*2002*	*2001*	*2002*	*2001*	*2002*
Non-consolidated	24	24	105	99	129	123
Consolidated	13	15	14	16	27	31[11]

1.8.2. Developments in the solvency ratio

The figures below are based on consolidated figures for banks required to calculate a consolidated solvency ratio.

At the end of 2002, the capital adequacy ratio reached a record level, benefiting both from the increase of eligible own funds and the decrease of total capital requirement. The solvency ratio itself lies at 14.3%, easily exceeding the minimum threshold of 8% prescribed by the current prudential regulations. Taking into account only core equity capital (Tier 1), the aggregate ratio for the Luxembourg financial market rose from 10.3% as at 31 December 2001 to a provisional figure of 11.9% at the close of 2002.

Lower activity in lending operations during 2002 resulted in a decreased rate of capital requirements to cover the credit risk (-5.6%). Lending operations still consume alone almost all coverage needs in terms of own funds. Own-fund requirements for coverage of risks linked to the banks' trading portfolios grew substantially as compared to 2001 (+26%), but remain negligible in terms of volume. Own-fund requirements for coverage of foreign exchange risks remain marginal, and confirm the downward trend that started in 2000.

Eligible own funds continue their positive development. Thus, core capital, which represents 83% of total eligible own funds, rose by 9.3% due to the rise in the item "Share premium accounts, reserves and profits brought forward". Following three consecutive years of growth, additional own funds (after capping) are stabilising with a (provisional) volume of EUR 7,348 million as at 31 December 2002, i.e. -4.9% as compared to the previous year. Subordinated liabilities of the type "Lower Tier 2", decreasing by 12.3%, are at the origin of this fall. The use of super additional own funds during 2002 needs to be noted. Finally, participations, which must simply be deducted from eligible own funds, stabilised at the level of the previous year (-2.9%).

[11] *Banks, the participating interests of which are deducted from own funds on an individual basis do not need to calculate a consolidated ratio.*

in millions of EUR

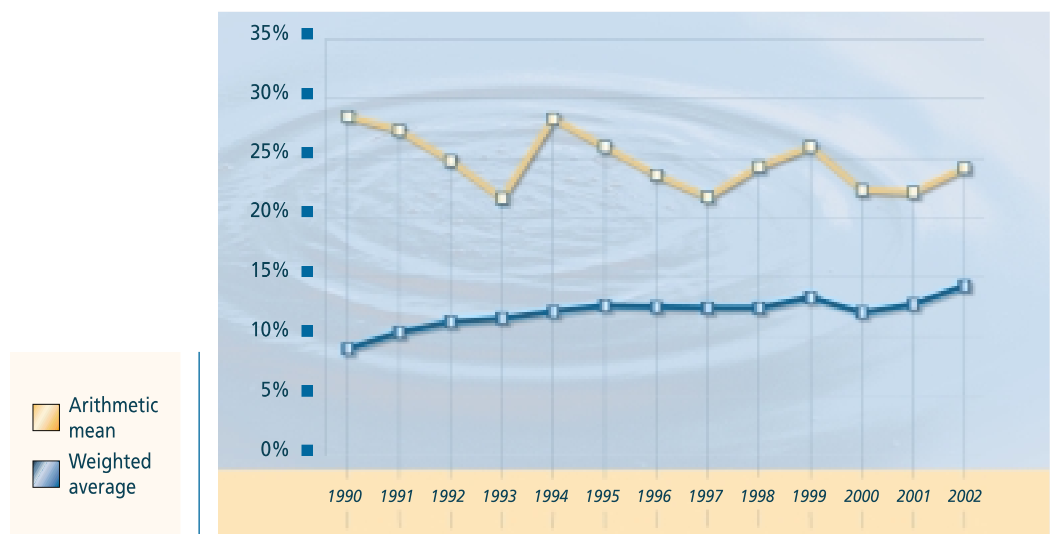
Numerator	*2001 consolidated*	*2002 consolidated (provisional)*
Original own funds before deductions	***22,567***	***24,748***
Paid-up capital	7,087	6,999
Silent participation	2,620	2,595
Share premium account, reserves and profits brought forward	10,011	12,277
Funds for general banking risks	1,996	2,036
Profits for the financial year	240	242
Specific consolidation items	613	598
Items to be deducted from original own funds	***-941***	***-1,102***
Own shares	-4	-10
Intangible assets	-90	-90
Losses brought forward and loss for the financial year	-59	-188
Specific consolidation items	-788	-814
ORIGINAL OWN FUNDS (TIER 1)	**21,626**	**23,645**
Additional own funds before capping	***7,878***	***7,387***
Upper TIER 2	***3,175***	***3,261***
Of which: cumulative preference shares with no fixed maturity	22	22
Of which: subordinated upper TIER 2 debt instruments	2,485	2,522
Lower TIER 2	***4,703***	***4,126***
Lower TIER 2 subordinated debt instruments and cumulative preference shares with fixed maturity	4,703	4,126
ADDITIONAL OWN FUNDS AFTER CAPPING (TIER 2)	**7,728**	**7,348**
Super additional own funds before capping	***0***	***121***
SUPER ADDITIONAL OWN FUNDS AFTER CAPPING (TIER 3)	**0**	**47**
OWN FUNDS BEFORE DEDUCTIONS (T1+T2+T3)	**29,354**	**31,041**
ITEMS TO BE DEDUCTED FROM OWN FUNDS	**2,500**	**2,427**
Items of share capital in other credit and financial institutions in which the bank owns a shareholding exceeding 10% of their share capital	741	707
Items of share capital in other credit and financial institutions in which the bank owns a shareholding less or equal to 10% of their share capital	1,760	1,720
ELIGIBLE OWN FUNDS	**26,854**	**28,614**
Denominator	*2001*	*2002*
TOTAL CAPITAL ADEQUACY REQUIREMENT	**16,872**	**15,962**
To cover credit risks	16,556	15,625
To cover foreign exchange risks	109	76
To cover trading portfolio risks	207	261
Ratio	*2001*	*2002*
SOLVENCY RATIO (base 8%)[12]	**12.7%**	**14.3%**
SOLVENCY RATIO (base 100%)	**159.2%**	**179.3%**
TIER 1 SOLVENCY RATIO (base 8%)	**10.3%**	**11.9%**

[12] *Eligible own funds/(total capital adequacy requirement * 12.5)*

The graph below shows the development of the solvency ratio (minimum 8%) since 1990. The weighted average is the ratio between total eligible own funds in the financial centre and total weighted risks. This average takes into account all credit institutions according to their volume of business. The arithmetic mean is the average of the individual ratios of all credit institutions regardless of their volume of business.

As at 31 December 2002, the weighted average reached 14.3% whereas the arithmetic mean reached 24.4%.

Developments in the solvency ratio (base 8%) since 1990



1.8.3. Developments of solvency ratio distribution (base 8%)

In non-aggregate terms, improvement in the solvency ratio in the financial centre is essentially reflected by a reduction in the number of banks, whose ratio is situated within the medium capitalisation band, i.e. below 11%, and by a substantial increase in the number of banks with a solvency ratio exceeding 20% (+15 entities). For instance, the proportion of banks with a solvency ratio below 10% fell to 4.8% as at 31 December 2002, while it amounted to 11.7% at 31 December 2001.

Ratio	Number of banks 2001	Number of banks 2002	as % of total 2002
<8%	0	0	0.0%
8%-9%	2	3	2.4%
9%-10%	13	3	2.4%
10%-11%	12	4	3.3%
11%-12%	6	9	7.4%
12%-13%	11	10	8.2%
13%-14%	11	6	4.9%
14%-15%	5	5	4.1%
15%-20%	25	24	19.7%
>20%	44	59	48.4%
Total	**129**	**123**	**100.0%**

1.9. International expansion of Luxembourg banks in 2002

From 1995 onwards, a certain number of Luxembourg banks started to develop their activities abroad, either by opening branches or by forming or acquiring subsidiaries within the financial sector abroad.

Luxembourg banks, being particularly competent in the field of private banking and asset management within the banking group they belong to, aimed to widen their customer base through growth at international level.

However, growth through internationalisation was more moderate in 2002 than in 2001. Only 6 subsidiaries were opened or acquired abroad in 2002 as against 11 in 2001. The number of new branches reached 5, as against 4 in 2001.

Many reasons explain this change of policy.

Firstly, the economic and stock market situation, which has been very difficult for two years now, does not favour the development of private portfolio management, which represents one of the key activities of Luxembourg banks and their branches abroad.

The sluggishness of stock markets had of course an impact on the profitability abroad, leading banks to revise their investment policy abroad and to opt for the consolidation rather than the expansion of their current network.

Moreover, banks often paid very high prices for participations they have taken, which now puts a strain on their means of investment.

Finally, it has to be noted that a certain number of internationally established banks already disposed of a network abroad in 2001, which roughly corresponds, as far as quantity and quality are concerned, with the strategy they set themselves in this field.

Name of the bank	*Entity formed or acquired*
SEB Private Bank S.A.	Opening of a branch in London
Svenska Handelsbanken S.A.	Opening of a branch in Zurich
Norddeutsche Landesbank Luxembourg S.A.	Acquisition of Skandifinanz/Bank AG in Zurich
John Deere Bank S.A.	Opening of a branch in Getafe (Spain)
Banque Puilaetco (Luxembourg) S.A.	Acquisition of 100% of Puilaetco (Switzerland) S.A., Geneva
American Express Bank (Luxembourg) S.A.	Opening of a branch in London
Dexia Banque Internationale à Luxembourg	Acquisition of 80% of Dexia BIL Holding (Hong Kong) Ltd.
Dexia Banque Internationale à Luxembourg	Acquisition of 61% of Dexia Fund Services DFS, Belgium
Dexia Banque Internationale à Luxembourg	Opening of a branch in Hong Kong
UBS (Luxembourg) S.A.	Formation of the bank UBS Private Banking (Belgium) S.A.
DZ Bank International S.A.	Acquisition of 100% of DG Capital Management GmbH

Branches established in the EU as et 31 December 2002

Country	*Luxembourg branches established in the EU*	*Branches of EU banks established in Luxembourg*
Germany	1	25
Belgium	1	2
Spain	1	0
Finland	0	1
France	0	7
Ireland	3	0
Italy	0	5
Portugal	2	2
United Kingdom	4	4
Sweden	1	2
Total	**13**	**48**

Freedom to provide services in the EU as at 31 December 2002

Country	*Luxembourg banks providing services in the EU*	*EU banks providing services in Luxembourg*
Germany	39	25
Austria	22	5
Belgium	46	17
Denmark	24	6
Spain	34	4
Finland	19	3
France	46	60
Greece	20	0
Ireland	19	26
[Iceland][13]	4	0
Italy	39	2
[Liechtenstein][13]	1	0
Netherlands	37	23
[Norway][13]	9	3
Portugal	23	7
United Kingdom	31	40
Sweden	18	1
TOTAL notifications	**431**	**222**
TOTAL number of banks	**65**	**222**

[13] *Although Norway, Iceland and Liechtenstein, members of the European Economic Area, are not members of the EU, these countries have implemented and apply the European Directive on the taking up and pursuit of the business of credit institutions.*

1.10. Exposure to high-risk sectors

The twenty most important credit institutions of the financial centre were requested by circular letter of 29 November 2001 to provide information concerning their positions on certain sectors more particularly hit by the unfavourable economic environment. Thus, they report, on a quarterly basis, their exposures towards the sectors of telecommunications, media and technology, transport, aviation, tourism and leisure industry, as well as insurance. These twenty institutions cover 66.9% of the total balance sheet and off-balance sheet items of the financial centre in 2002.

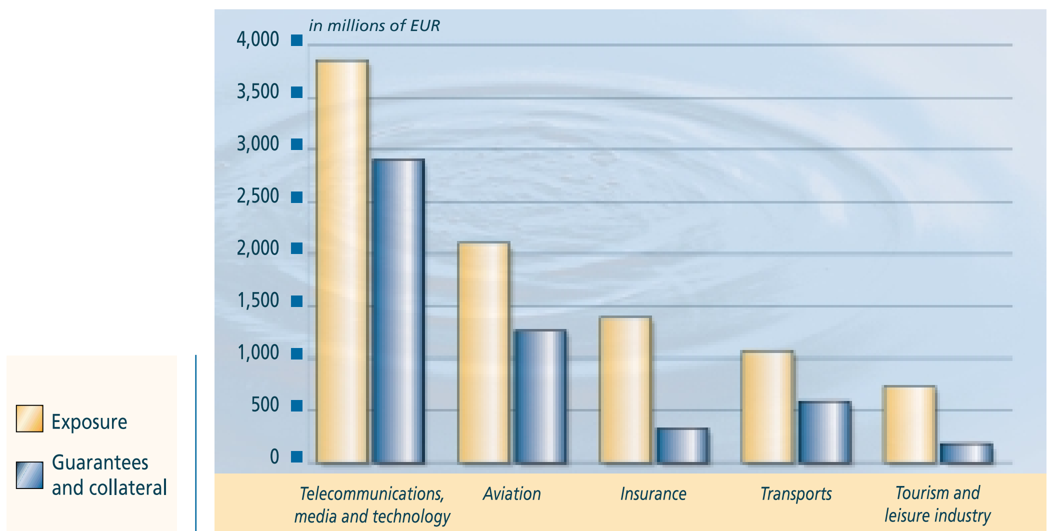
In 2002, the CSSF intensified its monitoring of the development of the reported risk exposures. The following table summarises the recent development of loans, net of specific provisions, drawn by the different sectors. The risk exposures taken into consideration globally represent 1.4% of the total balance sheet of the banks of the financial centre at the end of 2002.

in millions of EUR	*Exposure at the end of 2001*	*Exposure at the end of 2002*	*Variation in %*
Telecommunications, media and technology	3,986	3,855	-3%
Aviation	2,566	2,107	-18%
Insurance	1,618	1,392	-14%
Transport	1,492	1,071	-28%
Tourism and leisure industry	656	734	+12%

The global risk exposure positions recorded a substantial decrease of 11.2% during 2002. Exposure towards the transport sector registered the most significant decrease, i.e. 28.2% over the year. This development has to be put into the context of a fall by 13% of loans and advances to customers. Several large loans granted by banks, maturing during the year, had not been renewed.

The following graph shows the degree of credit risk mitigation of the exposures. Overall, the exposures are covered up to 50% through guarantees/collateral. The coverage ratio is highest for the telecommunications sector, media and technology (75.3%) as well as for the aviation sector (60%).

Risk positions at the end of 2002: exposure and guarantee/collateral



[13] *Voir Chapitre I, point 2.5.*

The CSSF applies strict eligibility requirements as regards guarantees and collateral. Only guarantees and collateral of high quality and liquidity are taken into account for internal analysis. In certain cases, haircuts that take into account the residual risk are deducted from the gross amount of guarantees.

The table below sets out own funds of banks with exposures to high-risk sectors. It also gives a fair outline of the coverage of risk exposures considered through own funds.

Sector	*Own funds of banks with risk exposures (in millions of EUR)*	*Ratio between exposure and own funds*	
		Highest ratio for systemic banks	*Ratio for the three most exposed banks*
Telecommunications, media and technology	21,344	42.3% (*)	28.9% (*)
Aviation	18,743	50%	43%
Insurance	15,948	21%	8%
Transport	19,896	21%	10%
Tourism et leisure	19,362	9%	8%

(*) highest ratio among those calculated separately for the telecommunications, media and technology sectors.

The first ratio analysed by the CSSF relates the risk-sector exposure to the own funds of the individual banks. For each sector, the table shows the highest ratio observed among the systemic banks. The second ratio calculates the same percentage as regards the three banks having the highest risk-sector exposures. Neither of these ratios indicates an abnormal concentration. The risk concentration of banks is highest for the aviation sector. However, the exposure towards this sector decreased substantially from the third quarter 2001.

Capital buffers constituted mainly by lumpsum provisions allow most of the banks to absorb possible losses incurred in high-risk sectors without their own funds being directly affected.

Several stress tests allowed the CSSF to better differentiate the quality of guarantees and the counterparty risk. Overall, these tests did not reveal a particularly preoccupying situation as regards the risk-sector exposures.

1.11. Banks issuing mortgage bonds

Three years after the issue of the first public sector mortgage bonds, the market for Luxembourg mortgage bonds has continued its positive development. Indeed, as at 31 December 2002, the balance sheet total of the three banks issuing mortgage bonds totalled EUR 20.03 billion and the total volume of public sector mortgage bonds issued by these three banks reached EUR 12.99 billion, compared with EUR 11.3 billion at the close of the financial year 2001.

Issues of mortgage bonds are guaranteed by ordinary cover assets and by substitute cover assets. As at 31 December 2002, cover assets totalled EUR 15.5 billion, meaning that the mortgage bonds in circulation benefit from total over-collateralisation of EUR 2.5 billion. The ordinary cover assets of municipal bonds for the three banks in question break down as follows:

- claims on or guarantees from public organisations: EUR 3.5 billion
- bonds issued by public organisations: EUR 9.8 billion
- municipal bonds of other issuers: EUR 945 million
- derivatives transactions: EUR 539 million

Besides these ordinary cover assets, the banks used substitute cover assets (other loans to credit institutions) amounting to EUR 660 million as at 31 December 2002.

Due to the faultless quality of investments of specialised banks and the scale of over-collateralisation in relation to the mortgage bonds issued, public sector mortgage bonds continue to receive an AAA rating from the rating agency Standard & Poor's. Indeed, the banks issuing mortgage bonds limit their investments by only including assets with a minimum AA rating as cover assets.

In order to protect mortgage bond holders and to further specify the missions and obligations conferred upon the auditor by the Law, the CSSF published on 26 February 2003 CSSF Circular 03/95 aiming to clarify the minimum requirements applicable to the management and the control of the mortgage register, cover assets and the ceiling of mortgage bonds in circulation.

2. Changes in the regulatory framework

2.1. CSSF Circular 02/63 on cross-border payments in euro

The Circular gives notice of Regulation (EC) No 2560/2001 of the European Parliament and of the Council of 19 December 2001 on cross-border payments in euro, published in the Official Journal of the European Communities (OJEC – L 344/13) of 28 December 2001. This Regulation lays down rules on cross-border payments in euro in order to ensure that charges for these payments are the same as those for payments in euro within a Member State.

The principle of equal charges will apply with effect from 1 July 2002 as regards cross-border electronic payment transactions in euro and from 1 July 2003 at the latest as regards credit transfers.

Until 2006, the Regulation is applicable to cross-border payments in euro up to a maximum of 12,500 euro. This amount shall be raised to 50,000 euro as of 1 January 2006.

While this Regulation currently applies to cross-border payments in euro, it can be applied to cross-border payments made in the currency of another Member State when the latter notifies the European Commission of its decision to extend the Regulation's application to its currency.

In order to ensure equal charges for cross-border transactions in euro, the Regulation lays down provisions concerning the transparency of charges. Thus, any modification of the charges shall be communicated to customers prior to their coming into force.

In order to facilitate cross-border transfers, the Regulation introduces the obligation in particular for credit institutions to communicate to each customer upon request his IBAN number (International Bank Account Number) and BIC (Bank Identifier Code) necessary for the automated cross-border transfers.

Furthermore, the Regulation stipulates that with effect from 1 July 2003, the persons effecting cross-border payments within the scope of their activities, shall indicate on statements of account of each customer, or in an annexe thereto, the client's IBAN and the BIC code of the person effecting the cross-border payments.

2.2. Electronic money institutions

The Law of 14 May 2002, amending the Law of 5 April 1993 on the financial sector, defines a legal framework governing the access to and the exercise of the activity of electronic money institutions. It has to be noted that no entity is established under this status in Luxembourg as at 31 December 2002.

This Law is more specifically commented at point 3.2. of Chapter X "Banking and financial legislation and regulations".

3. Prudential supervisory practice

3.1. Objectives of supervisory practice

Supervision of banks aims at the following:

- ensuring the security of the public's savings by monitoring the solvency and prudent management of individual banks;
- ensuring financial stability and proper functioning of the banking system as a whole;
- protecting the reputation of the financial sector by censuring ethically unacceptable conduct.

In order to fulfil these objectives of public interest, the CSSF monitors application by credit institutions of the laws and regulations relating to the financial sector.

3.2. Monitoring of quantitative standards

Quantitative standards, designed to ensure financial stability and risk spreading by credit institutions, relate to:

- evidence of minimum equity capital;
- a maximum ratio between own funds on the one hand and risk exposure on the other;
- limiting the concentration of risks on a single debtor or a group of associated debtors;
- liquidity ratio;
- limiting qualified participating interests.

In 2002, the CSSF did not have to intervene in any instances for violation of capital ratio. It intervened on eight occasions with regard to non-compliance of liquidity ratios and on ten occasions with regard to overstepping limits on large exposures. These breaches often resulted from difficulties in interpreting regulations and were rapidly regularised.

3.3. Monitoring of qualitative standards

In order to assess the quality of the banks' organisation, the CSSF relies on several instruments:

- Analytical reports prepared by external auditors;
- Management letters and similar reports prepared by external auditors;
- On-site inspections undertaken by CSSF agents;
- Reports prepared by internal auditors of the banks.

These reports are processed according to a methodology described in the CSSF's internal procedures. The reaction of the CSSF depends on the seriousness of the problem raised and whether it is repetitive in nature. It varies from simple monitoring of the problem on the basis of reports, through the preparation of deficiency letters *(lettres d'observation)*, to convening the bank's management or on-site inspection undertaken by CSSF agents. Where necessary, the CSSF may use its formal powers of injunction and suspension.

During 2002, the CSSF sent 204 (101 in 2001) deficiency letters to banks based on shortcomings in terms of organisation. As the new format of the analytical reports (please refer to point 3.4.) covers a broader range of fields, more detailed descriptions and assessments are now to be provided as concerns functions and risks. The increase in the number of deficiency letters is thus not due to a worsening of the quality of organisation and risks, but rather to the refinement of means of control at the disposal of the CSSF.

3.4. The new analytical report

The analytical report prepared by the external auditor is one of the most important instruments to assess the quality of the organisation and the exposure to different risks. The CSSF requires the preparation of an analytical report on a yearly basis for each Luxembourg credit institution as well as for each Luxembourg branch of credit institutions originating from countries outside the EU. Furthermore, credit institutions supervised on a consolidated basis are required to submit a yearly consolidated analytical report and individual analytical reports of each subsidiary included in the consolidation, carrying out an activity of the financial sector.

Analytical reports were made compulsory in 1989 through a Circular, which was reformed in 2001 (CSSF Circular 01/27) in order to take account of the development of the regulatory and prudential framework. The analytical reports prepared according to the new format were analysed for the first time in 2002.

Overall, the CSSF is satisfied with the quality of the new analytical reports, which are much more detailed as in the past and cover a broader range of subjects.

The CSSF is aware of the extra work the preparation of this document entails for external auditors, and of the subsequent increase of audit costs. However, it needs to be stressed that the quality of the report has a direct impact on the quality of the CSSF's supervision.

During 2002, the CSSF analysed 242 analytical reports, 24 of which were consolidated analytical reports and 89 were analytical reports of subsidiaries.

3.5. Co-operation with external auditors

In 2002, the CSSF intensified its co-operation with external auditors. In this context, it held meetings with the four main audit firms.

These meetings concerned in particular the quality of the analytical reports of 2001 which had been prepared for the first time according to the provisions laid down in CSSF Circular 01/27. The CSSF informed external auditors about the deficiencies it has observed during the analysis of the analytical reports and the auditors made suggestions for improving these analytical reports following the difficulties encountered during their preparation.

Discussions also concerned the differences the CSSF noted while comparing the results of its own on-site inspections with regard to money laundering with the observations made by the external auditors.

Moreover, this exchange of views allowed to address a certain number of specific issues concerning the activities of the banks of the financial market. In this context, the CSSF deemed it necessary to specifically convene the external auditors of two banks in order to discuss in detail their situation and the problems identified.

Considering the role and mission of external auditors in the context of the statutory audits of accounting documents, but also of the supervision of the organisation and internal audit of Luxembourg banks, the CSSF attaches a great importance to the independence of external auditors.

One of the most important aspects in this context is whether the external auditor, his firm or his group, provides, besides the audit of accounting documents, other services to the audited credit institution (such as consultancy, accounting, etc.). The CSSF requires this information within the context of the analytical report the external auditors must prepare in accordance with CSSF Circular 01/27 and started an analysis based thereon. Should this analysis reveal major problems as regards independence, the CSSF will take appropriate measures.

It should be stressed that the subject of independence of the external auditor is being discussed at international level. In May 2002, the European Commission adopted a Recommendation[14] relating to the independence of external auditors, through which it presented a set of fundamental principles the profession must comply with so as to guarantee the independence, objectivity and integrity of its work. But the European Commission also pointed out that it intends to present a broader strategy in terms of statutory audits of accounting documents, which will address issues such as the use of international auditing standards, the creation of a public supervision of the audit profession and the role of audit committees.

3.6. On-site inspections

The CSSF intensified its efforts as regards on-site inspections in 2002. Thus, 47 inspections were undertaken in 2002, as compared with 35 in 2001.

The programme of inspections to be carried out during the year is set up at the start of the year and is based on the evaluation of the risk areas of the various credit institutions. The objective thereof is on the one hand to be present at the important credit institutions and on the other to supervise the other institutions following a schedule covering several years.

Inspections carried out by CSSF agents generally follow standard inspection procedures, under the form of interviews with the persons responsible, assessment of procedures and the verification of files and systems.

During the year under review, special attention was attached to compliance with the rules as regards money laundering. Twenty-two inspections concerned this aspect (please refer to point 3.7. hereafter). Other inspections concerned various subjects such as market activity, the group leader function, information technology and lending activities.

[14] *Commission Recommendation of 16 May 2002: Statutory Auditor's Independence in the EU: A Set of Fundamental Principles (2002/590/EC).*

3.7. Combating money laundering

The CSSF pays special attention to the compliance by credit institutions with their professional duties in matters of money laundering offences. The CSSF uses the following instruments to supervise compliance with these rules: inspections carried out by CSSF agents, reports of external auditors and those prepared by internal auditors.

During the year under review, the CSSF sent 93 deficiency letters to banks in relation with shortcomings concerning money laundering. These letters are based on on-site inspections undertaken by the CSSF and on the reports of external or internal auditors.

In 2002, the CSSF carried out 22 missions to control compliance with anti-money laundering rules. The banks concerned were chosen according to volume and type of activity as well as to the origin of their clients. Results were generally positive as far as identification of customers and of the funds' origin are concerned. Furthermore, a high level of awareness of the persons responsible was noted.

The following weaknesses led the CSSF to intervene with the banks:

- Banks should not only note down customer declarations on the origin of funds but must require that probative documents be handed in;
- The procedures must contain a precise definition of customers who are "publicly exposed persons" and define particular modes for the opening and monitoring of these accounts;
- Swift messages must mention the name of the originator;
- Where banks apply group procedures as well as procedures developed by themselves and which take account of the Luxembourg specificities, it should be made clear which procedures prevail;
- As regards the supervision of operations in order to detect suspicious transactions, the setting up of computerised processes are more and more indispensable;
- Where technical aspects concerning the identification of customers are delegated to professional intermediaries, this co-operation must be settled by a regularly updated contract;
- Where the banks rely on independent intermediaries, they must enquire about the reputation of the latter and ensure that they have the appropriate authorisation to carry out this type of activity;
- The CSSF had to remind certain banks of the rule according to which each opening of account must be approved by a hierarchical superior;
- The CSSF reminded banks that employees likely to apply anti-money laundering rules must get regular training in order to be brought up to date on the fast developing regulations.

The programme of inspections for 2003 provides for the continuation of inspections concerning compliance with money laundering obligations.

The yearly analytical report prepared by external auditors must specifically cover compliance with legal requirements and the adequate application of internal procedures concerning the prevention of money laundering. The main deficiencies observed are about the same as mentioned above. Moreover, some deficiencies were observed as regards the following points:

- insufficiently documented accounts were not blocked in the computer system;
- lack of a list of insufficiently documented accounts.

The Law requires that banks with branches or subsidiaries abroad ensure that these entities comply with Luxembourg professional obligations in addition to the standards of the host country. The CSSF verifies compliance with this requirement by means of analytical reports of external auditors to be prepared for each subsidiary carrying out an activity of the financial sector. Furthermore, the CSSF requires that the internal audit of the Luxembourg parent company periodically verifies the compliance by subsidiaries and branches abroad with the

group's directives on anti-money laundering. The results of these inspections must be included in the summary report, which has to be submitted to the CSSF on an annual basis.

The CSSF had to intervene on several occasions with respect to weaknesses as regards the fight against money laundering observed at subsidiaries and branches abroad. It has to be particularly stressed that the groups' managements must pay special attention to this matter and ensure that the groups' directives be uniformly applied by all the entities.

- **Application of CSSF Circular 01/40 specifying the extent of professional obligations as regards the fight against money laundering**

CSSF Circular 01/40 sets out important details concerning the application of professional obligations:

- The obligation to declare any suspect operations that might indicate money laundering to the Public Prosecutor's Office has been extended to the situation where the professional has come into contact with a person or company without a business relationship being established or a transaction being executed.

- The presumption according to which a client (a lawyer or notary for instance), the normal professional activity of whom involves the deposit of funds of third parties with a professional of the financial sector, acts on his own behalf, is no longer justified. The financial professional must enquire whether the client acts on his own behalf or on behalf of a third party. In the latter case, the professional must check if the funds are connected with the normal professional activity of the client or if they arise from an activity of the financial sector, in which case the professional must identify the beneficial owners.

- The professionals have been reminded that the obligation to co-operate with the authorities implies that professionals must not invoke their professional secrecy when faced with an enquiry of the Public Prosecutor. Such an enquiry should lead the professional to consider whether he must on his own initiative declare a suspect operation.

The CSSF verified whether the procedure manuals of banks have been adapted to take account of these modifications. Thus, in its circular letter of 19 December 2001, the CSSF invited all the credit institutions of the financial centre to forward to the CSSF the part of their procedure manual concerning the fight against money laundering which takes account of the changes brought about by CSSF Circular 01/40. The CSSF analysed the responses by means of a checklist containing the requirements of the Circular and of the circular letter and checked whether their provisions were correctly and completely integrated into the procedures of all the banks.

3.8. Management letters

Management letters prepared by external auditors for the attention of the banks' management constitute an important source of information on the quality of the organisation of credit institutions. In these reports, the external auditors point out weaknesses they observed in the internal control system during their assignment. During 2002, the CSSF analysed 118 management letters.

3.9. Meetings

The CSSF regularly conducts meetings with bank executives to discuss the business market and any problems. It also requires prompt notification by the banks if a serious problem arises.

In 2002, 199 meetings were held between CSSF representatives and bank executives.

3.10. Specific controls

According to Article 54(2) of the amended Law of 5 April 1993 on the financial sector, the CSSF has the right to ask an external auditor to conduct a specific audit in a given institution. As in previous years, the CSSF did not formally make use of this right, but invited some banks to appoint themselves an external auditor to audit a specific area. Six controls of this type took place during 2002.

3.11. Internal audit reports

The CSSF takes into account internal audit work when assessing the quality of the organisation and risk management by analysing the summary report which the internal auditor must prepare each year. In 2002, the CSSF analysed 132 summary reports. It also requested 44 specific internal audit reports in order to obtain more detailed information on particular subjects.

3.12. Specific problems: fraud and malfunctioning

As in previous years, some banks were exposed to fraudulent activities of employees or malfunctioning of the organisation, which led to financial losses. The present section describes typical cases in order to enable banks to draw organisational lessons. These cases illustrate how compliance with certain essential organisational rules allows to prevent such situations, or at least makes them less likely to happen.

3.12.1. Irregular dealings of a bank employee on the basis of discretionary portfolio management

An employee of a bank, being charged with investment advice, actually provided discretionary management services to an important number of clients, without any customer having signed a formal portfolio management contract with the bank. The dishonest bank employee signed handwritten contracts drawn up on sheets of plain paper to be used as "pseudo-contracts" of discretionary management, which gave the impression to the clients that they had actually signed a real contract with the bank. The employee invested mainly in very speculative securities, which performed favourably as long as stock markets were rising.

Some transactions have been effected without clients having signed an order; other orders were signed by the clients after the transactions had already been carried out.

When the stock exchanges started to perform unfavourably, the employee succeeded for a while to conceal the losses sustained due to speculative investments from the clients by diverting their post.

As the stock exchanges further deteriorated, the clients became more and more insistent and started to lodge written complaints with the bank, leading to the unveiling of the employee's illegal practices.

Although the clients can be blamed for their somewhat naïve attitude, it needs to be stressed that the dealings of the employee were nonetheless facilitated by shortcomings of the internal control system.

Since stock orders were not double-checked, nobody questioned the high number of stock orders on highly speculative securities placed by the employee, although the investment of stock orders of this scope and nature were, in principle, incompatible with his functions.

Furthermore, non-compliance with the principle of separation of tasks as regards the management of the domiciled post allowed the dishonest employee to conceal and prolong his dealings so as to worsen the damage caused to his employer, who was obliged to indemnify the injured clients.

3.12.2. Failure to comply with limits and strategies set within discretionary portfolio management contracts

A private portfolio manager of a bank effected highly speculative transactions on important volumes without respecting neither the limits nor the strategies set out in the contracts of discretionary portfolio management.

Compliance of the portfolio management with the investment policy defined by the customer was insufficiently controlled. Instead of being regular and frequent, the controls were carried out very occasionally, so that problems were only detected when the damage was already done. The bank had therefore to respond favourably to the complaints lodged by injured clients.

3.13. Supervision on a consolidated basis

As at 31 December 2002, 31 banks under Luxembourg Law[15] (against 29 in 2001), as well as one Luxembourg-incorporated finance company[16] (idem in 2001) were supervised by the CSSF on a consolidated basis.

During 2002, the CSSF had to include in its consolidated supervision a certain number of banks whose subsidiaries either changed their status into financial establishment, or reached a volume of activities which triggers the supervision on a consolidated basis of their parent company. The increase in the number of banks subject to the supervision on a consolidated basis can be explained by regulatory aspects rather than by an expansion of the international network of Luxembourg banks.

The conditions governing submission to a consolidated supervision, the scope, content and methods of supervision on a consolidated basis are laid down in Section II, Chapter 3 of the amended Law of 5 April 1993 on the financial sector. The procedures in question implement Directive 92/30/EEC on the supervision of credit institutions on a consolidated basis. The practical application of the rules on supervision on a consolidated basis is explained in IML Circular 96/125.

Consolidated supervision is performed using specific reporting, as well as on the basis of reports to be prepared by the external auditors and covering the group and the various operating subsidiaries. Until now, the CSSF has not yet itself undertaken on-site inspections at foreign subsidiaries of Luxembourg banks.

The CSSF also investigates indirect participations of banks subject to its consolidated supervision in accordance with the terms of IML Circular 96/125.

3.14. International co-operation on matters of banking supervision

The CSSF has concluded memoranda of understanding with the banking supervisory authorities of most Member States of the European Economic Area[17] with a view to specify the terms of co-operation. These memoranda concern in particular the supervision of credit institutions involved in cross-border operations by way of the freedom to provide services or through the creation of branches.

In addition, in accordance with the legal provisions in force, the CSSF co-operates and exchanges information on an informal basis with a number of its counterpart authorities.

In 2002, the CSSF held five bilateral meetings with various banking supervisory authorities in order to exchange prudential information on institutions under supervision having a presence in both countries.

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[15] *ABN Amro Bank (Luxembourg) S.A., Banca Popolare di Verona International S.A., Banque Delen Luxembourg, Banque de Luxembourg S.A., Banque Degroof Luxembourg S.A., Banque Générale du Luxembourg S.A., Banque Populaire du Luxembourg S.A., Banque Safra-Luxembourg S.A., ING BHF-BANK International S.A., BNP Paribas Luxembourg, Commerzbank International S.A., Credem International (Lux), Crédit Agricole Indosuez Luxembourg, Crédit Européen S.A., Danske Bank International S.A., Deutsche Bank Luxembourg S.A., DekaBank Deutsche Girozentrale Luxembourg S.A., Dexia Banque Internationale à Luxembourg, DZ Bank International S.A., Dresdner Bank Luxembourg S.A., Europäische Hypothekenbank S.A., Fideuram Bank (Luxembourg) S.A., John Deere Bank S.A., Kredietbank S.A. Luxembourgeoise, Landesbank Schleswig-Holstein International S.A., Nordea Bank S.A., Norddeutsche Landesbank Luxembourg S.A., Sanpaolo Bank S.A., Société Générale Bank & Trust, UBS (Luxembourg) S.A., West LB International S.A.*

[16] *Clearstream International*

[17] *Namely Germany, Belgium, Spain, Finland, France, Ireland, Italy, Norway, Netherlands, Portugal, United-Kingdom and Sweden.*

Alongside the consultations required under European Directives, the CSSF informs the relevant authorities of all significant facts relating to supervision. In particular, it consults the relevant authorities regarding acquisitions of significant participating interests and restructurings of share ownership.

In 2000, the CSSF signed a memorandum of understanding with the Belgian and French authorities relating to supervision of the DEXIA Group. In 2001, a similar agreement, this time relating to supervision of the banking activities of the Fortis Group, was signed between the CSSF and the Belgian and Dutch authorities.

The authorities considered that the new structures of these groups, in introducing a decentralised organisation of operational management units and centres of competence, made an adaptation of the prudential supervision to the activities of these groups necessary. The key objective of such co-operation between authorities is to ensure that all banking activities of these groups are adequately supervised. To this end, the authorities are particularly careful to ensure that the various sets of regulations are applied in a harmonised manner in order to avoid any unbalanced treatment within the groups.

The co-operation between authorities is enacted on several levels:

- close consultation between the authorities to co-ordinate and align their prudential supervision;

- continuous and systematic exchange of information on any significant event likely to impact the group or its main constituent entities;

- regular consultation for the principal purpose of updating the list of points requiring the attention of the authorities within these groups, drafting of control plans and, finally, examining the appropriateness of on-site inspections to be carried out by the competent authority in close co-operation with the other relevant authorities.

Besides these frequent exchanges of information between persons directly responsible of the supervised entities in each authority, the CSSF attended five formal meetings within the framework of this co-operation.

The CSSF considers that this new form of co-operation substantially improves the effectiveness of supervision of cross-border banking groups and it is convinced that these can be supervised thoroughly by national authorities collaborating via memoranda of understanding so as to cover all dimensions of a group's activities. This underlines the belief of the CSSF that there is no need for centralised supervision of cross-border groups at EU level.

3.15. Compliance with CSSF Circular 01/32 relating to the disclosure of information on financial instruments

In 2002, the CSSF repeated a survey on banks’ compliance with the provisions laid down in CSSF Circular 01/32 relating to the disclosure of information on financial instruments.

This Circular, translating into Luxembourg regulations a Recommendation of the European Commission, introduced several disclosure requirements, that go beyond the provisions of the amended Law of 17 June 1992 relating to annual accounts and consolidated accounts of credit institutions governed by Luxembourg Law, with the aim to prompt credit institutions to increase, or even improve, transparency with regard to transactions on financial instruments.

Such increased transparency is necessary for the following reasons:

- since the adoption of Directive 86/635/EEC relating to the annual accounts and consolidated accounts of banks and other financial institutions, transactions on financial instruments, and more particularly on financial derivatives, have seen a considerable growth;

- banks, as well as other companies, are increasingly expected at international level to adhere to the principles of transparency, notably in order to enable investors and other players in the financial markets to take their decisions with full knowledge of the facts, thereby enhancing market discipline.

The information to be disclosed in accordance with CSSF Circular 01/32 is thus intended for investors, depositors, in other words to the general public. It is therefore essential that the management of a credit institution gets involved in the drawing up of the financial statements and ensures that the information allows the reader, who is supposed to be reasonably informed, to assess whether:

- the credit institution concerned is exposed to risks relating to effected transactions on financial instruments;

- the risks incurred are subject to a sound and prudent management.

The results of this study, which have been transmitted to the credit institutions concerned, showed that a certain number of points need further clarification. The following comments provide an overview of the general issues the CSSF encountered during the analysis. Furthermore, for certain areas they provide recommendations aiming to improve the quality and relevance of disclosed information.

3.15.1. General comments

The CSSF noted that all the credit institutions under review made more or less considerable efforts in order to meet the objectives laid down in CSSF Circular 01/32. Owing to the fact that this was the first application of the Circular, it was to be expected that certain provisions would give rise to problems of various nature.

As the information to be disclosed in accordance with CSSF Circular 01/32 is intended for the general public, it is absolutely necessary that the persons responsible of a credit institution ensure that the published information meets the aforementioned objectives.

Due to the differences of credit institutions as regards size, complexity or diversity of activities, the provisions of the Circular can obviously not be uniformly applied throughout the financial sector. The degree of detail of the disclosure should be adapted to the situation of the specific institution.

Although it is hence proving difficult to give recommendations, or even precise and generally valid examples concerning the application of the different provisions, the study did nevertheless allow to extract a certain number of points worthwhile to be mentioned in order to improve the quality of information provided.

The CSSF noted that, even though the provisions of the Circular had been more or less complied with strictly speaking, quantitative information was often reported out of context or without the explanations necessary for their understanding. Indeed, some credit institutions reported quantitative information without explaining what the indicated amounts represented.

As an example, one could mention disclosure on credit risk, where information on the risk-equivalent amounts of derivative financial instruments was reported without explaining how this amount was calculated. However, according to point 23 of the Circular, credit institutions are supposed to provide supplementary information on the terminology and presentation formats used, on risk measurement methods, underlying assumptions and, if needed, other parameters, where this additional information is likely to help readers of the financial statements to better understand the quantitative information.

3.15.2. Specific comments

Concerning the different parts of the Circular, the following comments need to be made:

- **Objectives/strategies and description of risk management**

a) The description of risk management objectives and strategies provided is, for the majority of banks, too summary. In general, banks should expand on the description of risks inherent in their activities, so as to allow the reader to better assess the stakes. A good perception of the risks incurred presupposes sufficiently clear description of a bank's activities.
Furthermore, in many cases, the descriptive part of the organisation of the department(s) in charge of risk management and of the assignment of responsibilities should be expanded upon. The organisational aspects should notably be completed by adding a sufficiently detailed description of the methodologies used in order to analyse and ensure the follow-up of the different risks, ideally including a description of applicable limits.
In general, all the credit institutions should develop the link between qualitative information provided in this part and the quantitative information given in the notes.

b) Annexe 1 of CSSF Circular 01/32 specifies, among other things, that qualitative information to be given in this context may cover operations on high-risk or complex financial instruments. It has been observed, however, that only a few credit institutions provided information on the use of these types of instruments, quite simply because the majority of institutions do not use such complex instruments. In this case, the CSSF recommends that this be explicitly mentioned so as to rule out any doubt.
This comment also applies to other areas where provisions of the Circular do not specifically apply to one institution.

c) Many credit institutions stated in their management report that the market risk, or part of this risk, is managed using a Value at Risk (VaR) type measure, without however providing the relevant explanations. Insofar as institutions use VaR type methods to assess the market risk, the published information should comprise a description of the risks managed using these methods, a description of the underlying assumptions for the calculation of the VaR as well as quantitative information on the values at risk. In order to ensure adequate appraisal of the extent of the risk concerned, it would be helpful to include a chart where the values at risk in the reporting year are compared to the applicable VaR-limit set by the bank. Where applicable, this type of information could also be provided by institutions subject to the simplified ratio regime.

d) Some credit institutions reported information on methods used to manage non-financial risk although CSSF Circular 01/32 did not require this type of information. It is recommended that the other banks of the financial centre follow this example.

- **Analysis of financial instruments**

a) Information on primary financial instruments

In general, information on primary financial instruments was adequate. While some credit institutions chose to detail this information in the notes relating to the corresponding balance sheet items, others chose to present the information in notes especially dedicated to financial instruments.

In most cases, breakdowns of instruments by geographic origin and economic sector could be improved. It should be noted in this context that breakdowns need not be repeated if they have been reported with the information on credit risk.

b) Information on derivative financial instruments

As far as the presentation of derivative financial instruments is concerned, it should be noted that many banks did not distinguish between assets and liabilities. The fact that the Circular requires information on derivatives broken down into assets and liabilities originates in the intention to provide the reader of the financial statements with information on the existence of any unrealised gains or losses.

If this distinction is not made, such an assessment cannot be made. However, if a bank wishes to maintain this type of presentation, it could follow the example of other banks that chose to report, further to the nominal value of the contracts, unrealised gains and losses.

Some credit institutions moreover chose to differentiate between transactions effected for the clients' account and for their own account. This sort of distinction is helpful in the sense that it allows to clearly determine which part of the transactions on derivative financial instruments have been effected for third parties. In numerous cases, the presentation could however be simplified and clarified so as to follow the provisions of the Circular more closely. The comments made in the two preceding paragraphs on the presentation of derivative instruments broken down into assets and liabilities particularly apply in this context.

As far as the presentation of interest rate swaps is concerned, it has to be borne in mind that these contracts are to be considered as financial assets if their market value is positive and as financial liabilities if their market value is negative. Thus, the different branches constituting a swap contract must not be reported separately, but the notional amount of the contract should rather be broken down depending on whether it bears an unrealised gain or loss.

- **Information on credit risk**

The Circular provides that quantitative information on credit risk must be based on the amounts that best represent the maximum credit risk exposure at the balance sheet date (net of any value adjustments or provisions and of any netting agreements that are legally enforceable by the institution), without taking account of any collateral. Information on the maximum credit risk must be completed by information on the potential credit risk exposure taking into account any collateral.

As a result, discussion of credit risk must cover both primary as well as derivative financial instruments. This information may be disclosed in a separate section on credit risk or in the notes relating to the different financial instruments. If the information is disclosed in a separate note, it should be provided in such a way as to allow reconciliation with the amounts disclosed in the analysis of financial instruments.

As regards primary financial instruments, it is in principle sufficient to note that the credit risk is equivalent to the notional amount of assets. This can be done in a note on credit risk or in the notes relating to the different balance sheet items. Where the credit institution opts for a note on credit risk, it may include a summary statement or a cross-reference to the notes on corresponding financial assets.

As far as derivative financial instruments are concerned, banks should ideally provide a table where instruments are broken down by types of instruments indicating notional amounts, replacement costs (current, potential future and/or global)- or the risk-equivalent amounts for credit institutions applying the original risk method- as well as net exposures. A breakdown by credit quality of the counterparties should be added as complementary information, but may be limited to notional amounts and net exposures.

In any case, the institutions must supplement quantitative information by qualitative explanations, in particular so as to explain the different measures.

If a credit institution is not exposed to any significant credit risk concentration, this should be stated explicitly.

- **Information on market risks**

The analysis of financial statements of credit institutions showed that a certain number of banks do not disclose quantitative information on market risk, notably because they are subject to the simplified ratio regime. Insofar as these banks use VaR type methods for the management of these risks, they could however consider disclosing general quantitative information on values at risk.

3.15.3. Conclusions

The quality of information on financial instruments improved compared to the previous year, even though the objectives of the Circular have not been completely met as yet. In this context, it is particularly important that the management of a credit institution, when preparing the financial statements, asks itself whether the information disclosed in accordance with CSSF Circular 01/32 really allows readers to correctly assess:

- the risks incurred by a credit institution in relation to its transactions on financial instruments;
- the methods and systems used to manage these risks.

It is only when these questions can be answered affirmatively, that a bank may consider to be fully compliant with the provisions of the Circular.

3.16. Supervision of the rules of conduct in the financial sector

In its Circular 2000/15, the CSSF specified the rules of conduct the supervised companies must observe, and which are laid down in Article 37 of the Law of 5 April 1993 as amended, transposing Article 11 of the European Directive on investment services.

These rules of conduct concern the relations of supervised companies with their clients and the markets. Their aim is to promote the protection of the clients' interests and the integrity of the market. Moreover, strict compliance with these rules is essential to rule out any legal risk in the relationship between banks and clients.

In order to provide adequate services to clients, the banks must enquire about the financial situation, investment experience and the objectives of the clients in relation to the services requested.

It is essential that the professional informs the client about the available products and services and any inherent financial risks. Moreover, the banks must dispose of material evidence proving that they complied with their duty of information. In order to be able to do so, they must include a written warning in the contracts to be signed by the clients. Clients wishing to invest in derivative products must sign a specific warning in addition.

The professional must also ensure to inform clients within a reasonable timeframe about their transactions and situation, notably in the event of significant losses.

Non-compliance with these rules may have serious legal consequences as regards the civil liability of the banks. Indeed, clients who sustained losses can invoke the nullity of the effected transactions, which may entail that banks register substantial losses.

The CSSF supervises that banks apply these rules notably by means of the analytical report prepared by the external auditor on an annual basis and which covers this aspect.

In 2002, the CSSF intervened with 18 banks on the basis of problems concerning the application of the rules of conduct. These interventions mainly concerned the following points:

- Clients have not been informed about retrocession of commissions obtained by the banks for transmission of orders to third parties.
- Clients have not been informed about the risks inherent in the products and services offered.
- Clients have not been immediately informed about the bad performance of their managed portfolio.
- The professional did not enquire about the investment experience of his clients nor about their investment objectives.
- The programme of the internal audit did not include the control of compliance with rules of conduct.

Finally, the banks must submit the advertising material they intend to use to the CSSF for approval. On several occasions, the CSSF required that changes be made so as to draw the attention of the clients to the risks inherent to certain products.

3.17. The compliance function in Luxembourg

3.17.1. The current framework

The CSSF currently studies the subject of compliance with the aim to develop principles of best practice to be implemented through a Circular, which comes in timely, as the Basel Committee on banking supervision just charged one of its working groups, the Accounting Task Force, with the drawing up of principles in this matter.

Within the scope of its studies, the CSSF notably conducted a survey involving about thirty banks and a number of associations (ABBL, ALCO, IRE, PRIM, IACI) in order to determine how the provisions of IML Circular 98/143 have been implemented and to allow the players of the financial market to express their views on certain conceptual issues.

Even though Luxembourg has yet to define detailed and specific rules in this field, there are already certain provisions within the legal framework applicable to players in the financial sector obliging them to set up a framework system allowing to verify legal, regulatory, statutory and ethical provisions.

IML Circular 98/143 on internal control more particularly requires that the audit department of a bank or a PFS verifies the correct application of legal, regulatory and statutory provisions as well as of the rules of conduct applicable to the activity and transactions carried out, unless this compliance function is assigned to a person specifically designated within the establishment.

This Circular thus stipulates that each credit institution or PFS has to ensure that its activities and operations comply with the laws, regulations and ethical standards governing the markets in which it operates, without however defining the way to proceed.

Furthermore, as regards the fight against money laundering and the prevention of the use of the financial sector for money-laundering purposes, IML Circular 94/112 clearly provides that each bank must designate a person in charge of ensuring compliance with regulatory provisions in this field as well as of the contacts with the Public Prosecutor's Office and the CSSF.

The introduction of a compliance function does not amount to the setting up of an additional level of supervision. It rather contributes to the co-ordination, organisation and structuring of control, already carried out in accordance with the provisions of the Circular on internal control, but which are often broken up and handled on different organisational levels.

It also contributes to identify, manage and control, and thus to avoid, reputational risks[18] and to reinforce corporate governance.

3.17.2. The concept of compliance

Firstly, the scope of compliance needs to be defined. Should the measures to be taken be restricted to the coverage of reputational risk resulting from the financial activities of a financial professional or would it be preferable to expand the scope of compliance to include measures allowing to avoid the risks of sanctions imposed by the supervisory authorities? Do aspects such as legal risks[19] and operational risks[20] need to be included?

From the CSSF's standpoint, which is that of a supervisory authority responsible not only for the supervision of the professionals of the financial sector, but also for the supervision of the financial markets, it seems inevitable to adopt a global, i.e. integral approach.

As a result, the compliance function must encompass all the measures aiming to avoid that the professional of the financial sector incurs any loss, financial or not, due to the fact that he did not comply with regulations in their broadest sense.

The compliance function therefore aims to achieve maximal control of these risks and, thus, to minimise losses of financial or other nature, which could result from the occurrence of such risks.

3.17.3. Results of the survey

Overall, most of the surveyed establishments share the CSSF's global approach.

It also seems to be generally accepted that, in light of the approach adopted in IML Circular 98/143 on internal control that distinguishes four levels of control, the compliance function contributes to the third level. It thus contributes to the controls carried out by members of the management on activities and/or functions falling within their direct responsibility. It notably assists the management in order to ensure compliance with regulations.

However, the responsibilities of the compliance function ought to go further. Indeed, besides the "control" part, the compliance function should also take on a proactive/preventive role, as it should prevent that a professional of the financial sector sustains any loss, financial or other, due to non-compliance with regulations in their broadest sense. Consequently, the compliance function must not only assist or advise the management in developing and setting up internal rules, but it must also ensure that the procedures correctly reflect compliance objectives.

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[18] *I.e. risk of negative publicity following malfunctioning, non-compliance with laws, rules and codes, which are deemed to be crucial by markets, investors and clients.*

[19] *I.e. the risk that transactions are effected based on legal notice or documentation presumed correct or adequate, but that proves wrong afterwards, resulting in a risk of cancellation of a transaction, a risk that transactions or guarantees are invalid and/or risk that the counterparty does not have the legal right to effect the transactions in questions.*

[20] *I.e. risk of losses sustained due to inadequate systems and/or procedures, committed frauds, etc..*

Moreover, the following principles can be drawn from the responses received:

- **Responsibility of the board of directors and the management**

As far as the responsibilities of the board of directors are concerned, the entities polled generally accept the active involvement of this body in the determination of compliance strategies as well as their follow-up and control. The board is in charge of promoting a positive attitude towards the compliance function.

Opinions diverge however as to the level the compliance function should be hierarchically attached to. Whereas some prefer that it be directly attached to the board or its chairman, others are in favour of a link to the management. Considering this situation, it is interesting to note that almost all the survey participants agree with the CSSF's position, according to which the compliance officer must, at least in case of need, be able to report directly to the board of directors or its chairman.

In principle, it is accepted that the management is in charge of implementing the standards approved by the board of directors. On a daily basis, many entities polled delegated the execution of the tasks relating to compliance to a specifically designated "agent". The management must obviously remain involved as regards the drafting of policies, procedures and codes of conduct and kept informed on a regular basis on the results of these efforts.

- **Existence of a formal policy**

Like the CSSF, the surveyed entities clearly favour the introduction of a formal and written policy setting out the outlines and directives with regard to compliance. This policy is implemented by means of directives, ethical codes (for the different business lines) and procedures. The management should also charge the compliance officer with the implementation of an adequate training programme.

The objectives of the compliance function follow from the conceptual approach. As the majority of entities polled seem to approve the global approach, the objectives of the compliance function are the following:

- compliance with laws and regulations, including all the Circulars;
- protection of the interests of the clients of the professional of the financial sector, i.e. compliance with the provisions of CSSF Circulars 2000/15 and 02/77;
- strict compliance with applicable provisions as regards the fight against money laundering;
- staff integrity[21].

It is also noteworthy that the entities polled seem to be unanimous that the compliance function, in order to be efficient, must be characterised by:

- its independence;
- its permanence;
- its power to issue advice and recommendations;
- its right to access every necessary information;
- its power to start investigations and own controls.

It is also generally accepted that the objectives and responsibilities of the compliance function must be governed by a charter formally approved by the board of directors and communicated to the entire staff.

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[21] *This includes the definition of and the compliance with fundamental values such as honesty, loyalty, fairness and vigilance, which must notably apply at operational level as well as concerning relations with brokers, independent intermediaries and suppliers.*

- **Activities and extent of works**

Responses are more divided as regards the tasks the compliance function has to carry out on a daily basis. According to the CSSF, the compliance function should fulfil on a daily basis organisation, information, co-ordination and supervision tasks, including more particularly:

a) Identification of compliance risks
In practice, this means that the compliance function must keep an updated list (in principle in co-operation with the legal department) of all the applicable regulations and define which areas are prone to compliance risks, for instance, because a certain regulatory aspect is not adequately dealt with in the bank's procedures.

b) Organisation
This should include the setting up of a code of conduct, the involvement in the development of procedures, the application of the charter as well as the maintenance and the updating of the list of applicable regulations.
The compliance function is also generally involved in the drafting of procedures that directly pertain to deontological aspects such as the fight against money laundering, rules of conduct of the CSSF Circular 2000/15, the rules defined in CSSF Circular 02/77 and the rules concerning insider dealing. As far as the setting up of procedures on other areas are concerned, it should at least validate them and ensure that the compliance related aspects of regulations are adequately dealt with.
The organisational aspects of the compliance function also comprise the maintenance, updating and distribution of all relevant information as well as staff training.

c) Control and corrective measures
The compliance function may also be involved in direct controls. This is in principle the case for areas directly linked to deontology such as controls relating to money laundering, confidentiality, rules of conduct and insider dealing.
All the deficiencies identified through controls on areas that are not directly linked to deontology, are to be transmitted to the compliance officer. The latter is in charge of centralising and documenting the pieces of information as well as analysing them to ensure their conformity with regulations. He must decide whether and which measures should be taken to remedy the deficiencies and ensure their monitoring.
The compliance officer must also ensure that standards and procedures enacted at local level are also complied with at group level. To this end, the surveyed entities recognise the use of a functional link between compliance functions set up at different levels within a group.

d) Internal reporting
The compliance function must ensure that deficiencies are reported to the persons in charge of the departments concerned and, depending on their seriousness, to the management or the board of directors. Periodic reports are also to be prepared for the board of directors.

e) Correspondence with the Public Prosecutor's Office and the CSSF as regards money laundering
Ideally, the compliance officer is also responsible for prevention of money laundering. As such, he is in charge of communicating with the Public Prosecutor's Office and the CSSF.

f) Scope
The surveyed institutions seem to be unanimous regarding the fact that the work of the compliance officer must cover all the segments of a bank's activities.

In general, the compliance function is closely linked to internal controls of first and second level. There is hence a real need in terms of co-ordination and co-operation with the persons in charge of these controls.

There is also a need for co-operation and co-ordination with the audit function, which can contribute to the identification of compliance risks, that require an updating of the standards and work procedures. Furthermore, the compliance function should coordinate its works with the legal department (if this department is separated) and risk management department.

Notwithstanding this need of co-ordination in order to reach its own goals, the compliance function evidently needs to be submitted itself to a control by internal audit.

- **Conclusion**

The results of the survey reveal that the large majority of the surveyed institutions seem to agree with the basic reasoning of the CSSF and with the general principles that should govern a "good" compliance function.

The CSSF will thus continue its efforts in order to draft during the second half of 2003 a Circular defining principles of best practice and allowing to set up an efficient and organised compliance function while maintaining a certain flexibility, notably to meet the needs of smaller-sized players.